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## Fighting Procurement Fraud

Mature supply management practices coupled with solid internal controls are the best weapons against procurement fraud in a supply chain organization.

**T**he average business loses 5 percent of its revenues to fraud, while corruption and billing schemes comprise more than 50 percent of the reported fraud, according to the Association of Certified Fraud Examiners. Supply management organizations that have mature procurement processes and effective internal controls are in a unique position to identify key procurement fraud indicators and help fight the war against procurement fraud in an increasingly global and vulnerable world.

Developing a mature procurement process is the first line of defense in guarding against procurement fraud. As most supply chain practitioners know, the procurement process can be analyzed in six phases, from procurement planning, solicitation planning and solicitation, to source selection, contract administration and contract closeout.

Procurement process maturity refers to the level of capability of these processes. Process maturity can be assessed by examining

questions such as:

- Does the supply organization have established, institutionalized and mandated processes for each of the six procurement phases?
- Are these processes documented, enforced and supported by senior management?
- Are these processes integrated with other functional areas throughout the enterprise, and periodically assessed to ensure efficiency and effectiveness?
- Does the organization establish lessons learned and best practices?
- Are continuous process improvement initiatives implemented to improve process capability?

### Solid Internal Controls

Mature procurement processes, however, are just half of the battle, because organizations also need strong, effective internal controls. The internal control framework is a process that provides organizations with a reasonable assurance of meeting the objectives of reliable financial reporting, operational effectiveness and efficiency, and compliance with applicable laws and regulations.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO), an initiative dedicated to providing

thought-leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence, has identified five components of an internal control framework. These components serve as a general framework for developing policies, procedures and practices for an organization's internal controls.

**Control environment.** The control environment sets the ethical tone at the top of an organization. It involves implementing a code of ethics and conduct, management's philosophy and operating style, the organizational structure, reporting lines of authority and responsibility, and workforce policies and practices.

**Risk assessment.** This is the process of determining any potential risks that could occur, including business and fraud risks. A risk assessment ascertains to what extent the risks will occur and develops ways to mitigate them. The overall impact of the potential risks should be evaluated in view of the supply organization's objectives.

**Control activities.** Control activities include the procedures, standards, policies and rules within the supply chain organization to help protect assets and deter fraud. Examples of control activities encompass segregation of duties, information processing controls and physical controls.

**Information and communication.** This component includes internal and external



communications, as well as the accounting system within an organization. All stakeholders, such as suppliers, regulators and customers, have a vested interest in proper and effective communication, and reliable, timely data and information.

**Monitoring activities.** The monitoring activities component includes ongoing evaluations to assess whether the established control procedures are working properly. A cost-benefit analysis also needs to be performed for all control activities to ensure that the cost does not exceed the benefit of implementing certain control activities.

### Know the Weak Links

Organizations with less-than-effective internal controls are susceptible to fraud throughout the procurement process. The following is an example of how that can impact the procurement process at each phase.

**Procurement planning.** Splitting procurement requirements in order to avoid higher-dollar threshold review and approvals could occur without good controls. As a preventive control, the organization should monitor the frequency of purchases for the same or similar items.

**Solicitation planning.** A weakness could result in the supply chain organization approving a justification for other-than-full and open competition based on improper reasons, which may indicate potential fraud. As a preventive control, supply management leaders should conduct proper reviews of the justification for single or sole-source procurements.

**Solicitation phase.** A weakness in the control activities within this phase could result in the organization restricting procurement to exclude qualified suppliers. As a preventive measure, the supply management organization should

ensure the widest visibility of procurement opportunity announcements to all qualified suppliers.

**Source selection.** A weakness in information and communication as well as the control environment in this phase could result in the supply organization revealing a supplier's trade secrets to another supplier in exchange for financial gain. As a preventive control, the supply organization should establish tighter controls to better protect proprietary information to avoid this type of procurement fraud.

**Contract administration.** In the contract administration phase, an information and monitoring weakness could result in the supply chain organization modifying the contract to make unauthorized material changes to the statement of work. To prevent this, the organization should implement effective contract change control procedures to lessen this vulnerability to fraud.

**Contract closeout.** Without proper controls in this phase of the procurement process, someone could alter, backdate or modify contract documents to cover up procurement anomalies. One preventive control would be to ensure that procurement documents are adequately controlled throughout the contract closeout to avoid any unauthorized alterations.

### Beware of Other 'Schemes'

In addition, bid rigging, kickbacks, bribery and conflicts of interest, are examples of procurement fraud schemes in supply management.

Bid rigging, which could occur in the solicitation phase, entails collusion between suppliers to rig bids, fix prices and artificially increase the prices of goods and services offered in bids, which hinders competitive bidding.

To deter this type of fraud, supply organizations should ensure adequate control procedures.

These may include reviewing the procurement history and conducting a detailed cost analysis, which would entail a closer look at the supplier's proposed cost elements, including direct labor, direct materials and so forth.

Additionally, kickbacks, bribery and conflicts of interest can occur during any procurement phase and reflect an intent to defraud. These include providing something of value in exchange for influential actions or preferential treatment, compromising independence, playing favorites and making biased decisions. Supply organizations should be cognizant of suspicious third-party relationships and ensure that employees adhere to the organization's code of ethics and conduct.

### Protect Against Vulnerabilities

Although mature procurement processes and effective internal controls are needed to deter procurement fraud, our research has found that procurement practitioners have insufficient knowledge of procurement fraud indicators and lack confidence that their organizations will properly respond to reported incidents of potential fraud.

As today's supply management organizations continue to globalize their supply chains, they will continue to be vulnerable to supply-related fraud. Having mature procurement processes and effective internal controls will help supply management organizations be well-equipped for fighting the war against procurement fraud. **ISM**

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